Committee on Financial Services
Hearing on Compensation Structure and Systemic Risk
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Testimony from Nell Minow
Editor, The Corporate Library

Mr. Chairman and Members of the Committee, thank you very much for inviting me back to continue the discussion of executive compensation and the role it has played in providing perverse incentives and rewarding strategic decisions that were contrary to sustainable growth. In previous appearances before this committee both before and after the economic meltdown of late last year, I have called executive compensation both example and symptom of the greater instability in the financial services sector and our capital markets.

I am here as a passionate capitalist. I want executives to create shareholder value and I want them to earn a lot of money when they are successful. But I do not want them to be paid a lot of money when they fail. Pay that is disconnected from performance is a critical element in the bad decisions that lead to economic catastrophe.

In a May 28 essay in the Wall Street Journal, Professor Alan Blinder summarized the problem in an essay titled, “Crazy Compensation and the Crisis: We’re all paying now because skewered financial incentives led to too many big bets.” He describes the “skewed incentives,” a heads you win, tails we lose pay plan that based on the “simple” notion that we “give smart people go-for-broke incentives and they will go for broke.” He summarizes the consequences succinctly with a technical economic term: “Duh.”

Blinder describes the past well but his most important point is that nothing has changed.

> Amazingly, despite the devastating losses, these perverse pay incentives remain the rule on Wall Street today, though exceptions are growing. For now, excessive risk-taking is being held in check by rampant fear. But when fear again gives way to greed, most traders and CEOs will have the bad old incentives they had before – unless we reform the system.

Americans are generous in times of need and forgiving of mistakes. But we are outraged at injustice. If people make poor choices, we understand. But if they profit at our expense from the consequences of those choices, we are appalled.

Out-of-control pay has damaged our financial markets in every category, not just because it rewards bad choices but because it fundamentally undermines the credibility of our financial markets. The meltdown has opened up the market to new exchanges and new financial centers. Along with globalization and technology, these factors will have the potential for devastating long-term impairment of our ability to maintain primacy in the world markets. We have no ability or wish to hold back technology or globalization. That is all the more reason that the elements we do have control of, the transparency and alignment of interests between the providers of capital and the people who deploy that capital, must be immediately and indisputably credible, competitive, and incorruptible.

Unfortunately, that does not seem to be the way things are going. So I will speak briefly about what went wrong in the past but will spend most of my time on my concerns about what is happening now that repeats and even expands on our biggest pre-meltdown mistakes.

It is not difficult to figure out the problem with the structure of pre-meltdown compensation by focusing on the results. The markets crashed and the same people who made the choices that led to the crashes got paid more money than most people who do their jobs right. A little over three years ago, in my previous testimony before this committee, I said:

> In the 1990s, the cult of the CEO was based on the idea that vision and the ability to inspire were what made the CEOs worth the hundreds of millions of dollars they were paid. But a book by Harvard Business School professor Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*, makes a compelling case that corporate boards err seriously when they pick chief executives based on "leadership" and "vision" or when they pay huge premium pay that is not sensitive to performance to attract a “superstar.” Bringing in a CEO with a great record at another company may give the stock price a short-term boost. But high-profile transplants such as Al Dunlap at Sunbeam (which went into bankruptcy) and Gary Wendt at Conseco (which went into bankruptcy), CEOs should have to make the same disclaimers that money managers do: "Past performance is no guarantee of future performance."
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> Disclosure is important. The SEC’s proposed rules are a step in the right direction. But disclosure only matters if the people who absorb this information have the ability to act on it, and that is not currently the case. Executive compensation is a hydra-headed monster – every attempt to cut off one-head results in the growth of two more. Current abuses include these seven deadly sins of executive compensation:
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> 1. Accelerated vesting of options
> 2. Manipulation of earnings to support bonuses
> 3. Imputed years of service
> 4. Setting the bar too low (guaranteed bonus)

5. Outrageous departure and retirement packages
6. Stock options that are not performance-based (including back-dating)
7. Perquisites and gross-ups

I emphasized in 2006 that compensation must be looked at like any other asset allocation, in terms of return on investment. Instead, compensation consultants – selected by management and board compensation committees – selected by management rely on highly artificial formulas tied to even more artificial comparables that constantly ratchet upward in a sort of Lake Wobegone where all CEOs are above average.

The most pernicious elements of past bad pay were:

1. Payments based on a performance targets that have no relationship to sustainable value. At Bear Stearns, bonuses were to be awarded on the basis of nine metrics. But it was within the discretion of the directors to award all of the bonus for the achievement of any of the metrics. That is like throwing a dart at the wall and then drawing the bull's eye around it. Indeed, the board at Bear Stearns did decide to award all of the bonuses for the achievement of only one of the metrics. And we all know what the result was – the company imploded.

2. Incentives tied to the quantity of transactions rather than the quality of transactions.

3. Payments based on numbers retrospectively adjusted due to mistake or fraud with no obligation to return the money even though it was not actually earned.

The most pernicious elements of current and future pay plans are:

1. De facto or de jure repricing of options. Most current options are under water. As a shareholder, I would like that fact to be very motivating for managers to work harder to get the stock price to rise above the option strike price. But instead, it is very motivating for managers to get new options, essentially to reboot their compensation. Shareholders, of course, get no such luxury. It is infuriating – and unjust – for managers to get the benefit of the overall market when times are good but not to bear any of the risk of the overall market when times are bad. Some calculations show that as much as 70 percent of stock option gains are attributable to the market as a whole. This is indefensible. What we are seeing now is companies awarding new options to replace those that are underwater so that executives will benefit from the stimulus package and the inevitable market cycle instead of benefiting from increasing value at their own companies.

2. Awarding options without regard to particular performance goals and without indexing. Option grants that are not indexed to the peer group or the market as a

whole and that are not tied to performance goals within the power of the individual receiving the award do not have any meaningful motivational impact.

3. Increases in base pay to make up for reductions in performance-based awards or perquisites. Our senior research associate, Paul Hodgson, notes that companies like to use the term “adjustment” when what they mean is “increase.” He points to Morgan Stanley as a good bad example. He wrote:

> The American Recovery and Reinvestment Act? Limit incentive compensation to one third of total annual compensation with delivery in stock to vest after the U.S Treasury investment has been paid back. The reaction? Double everyone’s base salaries….This is what Morgan Stanley said in its May: 8-K filing
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> The base salary for Chairman and Chief Executive Officer John J. Mack remains unchanged at USD 800,000. For other officers, new base salaries are as follows: USD 800,000 for James Gorman (Co-President), GBP 525,000 which is intended to be approximately USD 800,000 for Walid A. Chammah (Co-President)[formerly GBP 170,000 in 2008 and, until May 2009, GBP325,000], GBP 490,000 which is intended to be approximately USD 750,000 for Colm Kelleher (Chief Financial Officer) [formerly GBP 170,000 in 2008 and, until May 2009, GBP220,000] and USD 750,000 for each of Gary G. Lynch (Chief Legal Officer and Vice Chairman) and Thomas R. Nides (Chief Administrative Officer) [formerly USD 400,000 in 2008]…. The base salary changes, which are effective as of May 1, 2009, were made after consultation by the Committee with its independent compensation consultant [Hay Management Consultancy].
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> These salary “adjustments” [it’s funny how salaries are never increased, they are only ever “adjusted”] were approved as part of the changes to compensation policy announced in the company’s 2009 proxy statement, refocusing compensation away from being based on annual incentives to a mix of fixed pay, short and long-term incentives. Hardly a pay revolution. The Compensation, Management Development and Succession Committee also goes on to state that the “salary adjustments” are not intended to increase total annual compensation but merely to “adjust” the mix of pay.
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> O.K., so let’s look at annual compensation lately for Morgan Stanley executives. Neither Mr. Mack, Mr, Chammah, nor Mr. Gorman received annual bonuses in 2008. So, for Mr. Chammah, for example, instead of the $322,903 total annual compensation he received in 2008, he will receive approximately $673,016, at least, in 2009. That seems like an increase in total annual compensation to me.

Of course, Morgan Stanley's peer group for pay has not so much changed as disappeared. With the merger of Bear Stearns with JPMorgan Chase, the bankruptcy of Lehman Brothers and the sale of Merrill Lynch to Bank of America last year, its investment bank competitor group has changed beyond recognition. Salaries were pretty low at these investment banks, but now that Morgan Stanley is "competing" with the likes of Bank of America, Wachovia, and so on, base salaries are somewhat higher in the peer group. Job doesn't change, but the peer group does, so salaries go up. Doesn't happen in any other office but the C-suite.

Now, I don't want to discourage a bank from refocusing on long-term performance rather than dishing out huge rewards for hitting annual earnings targets, but increasing – let's call a spade a spade for once – base salaries is not the way to do it.

4. That last point is worth reiterating: we need to watch for manipulation of the peer group to support higher pay. When pay would be higher by assigning a peer group based on sector rather than market cap, the board will adjust the peer group accordingly. When it goes the other way, so will the board.

5. Gross-ups. There is no justification under any circumstances for having the shareholders pay an executive's taxes.

6. Phony reductions. Greg Ruel of our company reported on 41 CEOs who were paid just one dollar a year in salary but collectively were paid more than $173 million through other means. We have observed a general weakening of the target-setting process – if the targets are easier to achieve, then the pay will stay the same while performance deteriorates.

I wish I could point you to a company that we think does it right but we do not have one. I can tell you some of the elements of pay plans that seem to the best job of aligning pay and performance, but caution you that there is a very big however coming up.

These elements of pay are consistently correlated with superior returns:

moderate severance benefits;

moderate, frozen or capped retirement benefits;

plans that allow officers to defer income and/or bonuses into restricted stock or other deferred accounts, but no discounts are applied to the stock and no matching shares or awards are granted;

benefits that are generally company-wide, or, if there are executive level benefits, they were moderate and were not grossed-up for income tax.

We like to see:

1. Indexing options and tying option grants to specific performance goals, as discussed above. Regardless of the form of compensation, if relative performance is being measured, executives should only be rewarded for levels of performance that are at or above the median of the peer group.

2. Banking of bonuses, preferable to clawbacks, a kind of escrow to ensure that any adjustments to the financial reports will result in adjustments to the bonus. This is essential not just in cases of fraud but also in cases of mistake, even honest mistake, because (a) there is no reason that executives should be unfairly enriched due to a mistake, (b) there is no reason that shareholders should have to pay for a mistake within the authority of the executives, (c) a bonus that is all upside and no downside provides a perverse incentive to be careless at best and manipulative at worst in preparing financial reports, and (d) intention is relevant to proving fraud but it is not relevant to determining the appropriate level of bonus. Just because a clerk at a retail store makes a mistake in giving you too much change does not mean you are entitled to keep it.

In the case of cash compensation deferral should be mandated for a minimum of three years and should apply to at least 50 percent of any award. In the case of equity compensation deferral should be mandated until three years into the executive's retirement and should apply to at least 75 percent of any award

3. Severance under any "not for cause" termination should be limited to a single year's salary and benefits, plus any unvested stock awards should continue to vest on their normal schedule for only that 12-month period.

4. Incentive compensation should be based on more than one performance metric. Different performance metrics should be rewarded from within a single incentive plan rather than multiple plans each measuring a single metric

5. Incentive compensation should measure performance over periods of one year or more. Multi-year vesting schedules do not measure long-term performance, so any long-term incentive compensation must be based on the measurement of two or more performance metrics over periods of three years or more.

6. Different incentive awards should measure different kinds of performance

7. Companies should ensure that compensation policies are easy for both executives and shareholders to understand and should avoid multiplication of compensation plans, particularly incentive plans

8. Long-term compensation should always make up the majority of total realizable compensation for the most senior executives at the company.

We find that works is when compensation which is not performance-related plays a fairly small role in total compensation. Many of the companies that do best pay executives below-median base salaries. And they are careful about what their performance goals are. It works well to base performance pay on some form of return on capital measure – often a better measure of value growth than earnings – and, in many cases, these return measures also take into account the cost of capital, rendering the metric an even more efficient measure of value growth. There is no one best practice for the form of long-term incentive practice. Some companies opt solely for stock options, some for time and/or performance-restricted stock, and some for other performance-related long-term incentives.

Paul Hodgson, who wrote both our "Pay for Failure" and "Pay for Success" reports, said that at the best performers the

> presiding compensation philosophy was twofold: simplicity and moderation. In most cases, a single form of long-term incentive was used, supplemented occasionally with additional types of grant. Where there was more than one kind used, at least one of the elements was granted at very restrained levels. In contrast, many of the Pay for Failure companies were guilty of throwing every kind of long-term incentive at their executives, in the hopes that one of them, at least, would pay out.

I promised a "however," though, and here it is. The tricky part is getting there. Even if I could come up with an ideal template for executive compensation at financial companies, we have to recognize that there is no structure that cannot and will not be immediately subverted. The corporate community and its service providers, including lawyers and compensation consultants, will always be more motivated and more agile than any legislator or regulator can anticipate. While I think it could be worthwhile for Congress and the Treasury Department to come up with a template to be applied on a "comply or explain" basis, nothing meaningful will change until we change the boards of directors. And as long as the government is a provider of capital, it should be in a position to reject an opt-out of the template as inadequately justified.

But the key is the board. It is unfathomable to me that most of the very same directors who approved the outrageous pay packages that led to the financial crisis continue to serve on boards. We speak of this company or that company paying the executives but it is really the boards and especially their compensation committees and until we change the way they are selected, informed, paid, and replaced we will continue to have the same result. Until we remove the impediments to shareholder oversight of the board, we cannot hope for an efficient, market-based system of executive compensation.

Directors should not be allowed to serve unless they have received majority vote of the shares cast. That way, investors will be able to remove directors who approve dysfunctional pay packages. I support “proxy access,” to permit shareholders to have their candidates for the board on the company’s proxy, but I expect that to be used in a fraction of a percent of the elections each year. “Say on pay” would be useful but not sufficient for meaningful change. Every director should have to earn the support of a majority of investors every year; that will do more than any other change to ensure that directors remember where they owe their loyalty.

The government has done a poor job of making it possible for regulated institutional investors like mutual funds, banks, money managers, pension funds, and foundations to cast proxy votes in an economically optimal manner. Due to the collective choice problem and conflicts of interest, proxy voting has too often been compromised and “rationally ignorant.” As we look at the “supply side” of executive compensation, management and boards, we must also look at the “demand side” to make sure our investor community has the information, tools, and ability to respond effectively.

I would like to thank Paul Hodgson and the staff of The Corporate Library for their assistance in preparing this testimony and the underlying data and analysis. I look forward to your questions.